

Income of State investment fund. Income from a fund, established under a written declaration of trust by a State, for the temporary investment of cash balances of the State and its political subdivisions, which purchase units of participation and have an unrestricted right of withdrawal, is excludible from gross income; however, the fund is classified as a corporation and must file a Federal income tax return.

'Advice has been requested whether under the circumstances described below the income of an investment fund established by State X is excludible from gross income and whether the fund will be required to file a Federal income tax return.

'In the normal course of their operations, State X and its political subdivisions would receive and hold substantial amounts of cash revenues in excess of the funds needed to meet current expenses. In order to obtain a yield on these cash balances, the State and its political subdivisions would invest them in any one of a number of legal investments.

'In 1975, to enable the State treasurer to create an effective mechanism for the management of these cash balances, the State legislature of State X enacted a statute enabling the State treasurer to establish, with the advice of an investment advisory counsel, one or more combined investment funds for the purpose of investing funds of State X and its political subdivisions. The statute authorizes the State treasurer to sell participation units in any such combined investment fund to State X and its political subdivisions, and the statute specifically makes such participation units legal investments for State X and its political subdivisions.

'The State treasurer proposes to establish the investment fund under State X law by a written declaration of trust. The fund is specifically designated as an instrumentality of State X. The fund will be managed by its trustee, the State treasurer, who will have complete and exclusive control over the management, conduct, and operation of the fund, including the power to vary the fund's investments.

'The investment objective of the investment fund will be to seek as high a level of current income as will be consistent with the preservation of capital and liquidity. The fund will seek to achieve this objective by investing and reinvesting exclusively in high-grade money market instruments.

'The net income of the investment fund will be determined at the close of business on each business day. All the net income of the fund so determined will be allocated among and accrue to State X and its political subdivisions at the time of such determination in proportion to the number of units then held by

each participant. Each participant will be entitled to withdraw any amount from its account in the fund at any time.

'Section 115(1) of the Internal Revenue Code of 1954 provides that gross income does not include income accruing to a State or a political subdivision thereof derived from the exercise of any essential governmental function or from a public utility.

'Section 6012(a)(2) of the Code provides that returns with respect to income taxes under subtitle A shall be made by every corporation subject to taxation under subtitle A.

'Section 1.6012-2(a)(1) of the Income Tax Regulations provides that every corporation, as defined in section 7701(a)(3) of the Code, subject to taxation under subtitle A (except charitable and other organizations with unrelated business income and certain foreign corporations) shall make a return of income regardless of whether it has taxable income or regardless of the amount of its gross income.

Section 301.7701-4(c) of the regulations provides, in part, that an investment trust of the type commonly known as a management trust is an association, and a trust of the type commonly known as a fixed investment trust is an association if there is power under the trust agreement to vary the investment of the certificate holders.

'A comprehensive interpretation of section 115(1) of the Code is set forth in G.C.M. 14407, XIV-1 C.B. 103 (1935), as superseded by Rev. Rul. 71-131, 1971-1 C.B. 28, in discussing the corresponding section of a prior statute (section 116(d) of the Revenue Act of 1934). It is indicated therein that the predecessor section of what is now section 115(1) of the Code was intended to refer, not to the income of a State or municipality resulting from its own direct participation in industry, but rather to that part of the income of a corporation engaged in the operation of a public utility or the performance of some governmental function that accrued to a State or municipality. It was pointed out that it may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the State government which, on a broad consideration of the question, may be the function of the sovereign to conduct.

'The investment fund in the instant situation is a separate entity of the type discussed above. The investment of positive cash balances by a State or political subdivision thereof in order to receive some yield on the funds until needed to meet expenses is a necessary incident of the power of the State or political subdivision to collect taxes and other revenues for use in meeting governmental expenses. The investment of funds by a State or political subdivision in an investment fund of the kind

involved in this case constitutes the exercise of an essential governmental function for purposes of section 115(1) of the Code.

'Section 115(1) of the Code does not provide that the income in question must accrue only to a State or a single political subdivision of a State. The accrual to a number of political subdivisions of a State as well as to that State itself is therefore not inconsistent with the statute. Since the participating political subdivisions and State X have an unrestricted right to receive in their own right their proportionate share of the investment fund's income as it is earned, the fund's income accrues to them within the meaning of section 115(1).

Accordingly, the income of the investment fund derived from the operations as described above is excludible from gross income under section 115(1) of the Code. However, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a corporation that is subject to taxation under subtitle A, will be required to file a Federal income tax return each year.